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Editorial

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The JOURNAL *of* ACCOUNTANCY

Official Organ of the AMERICAN INSTITUTE OF ACCOUNTANTS

A. P. RICHARDSON, *Editor*

EDITORIAL

The Institute Meeting

The tenth annual meeting of the American Institute of Accountants, held at Atlantic City, September 21 and 22, 1926, was a striking demonstration of the steady upward growth of the accounting profession in America. The discussions were conducted on a high plane and throughout all the sessions there was manifest a dignified esprit de corps. Accountants from all parts of this country and visitors from Canada participated in the activities. The results of the meeting will doubtless be helpful to the entire profession. Several matters of far-reaching importance to accountancy were considered and it was evident that the intent at all times was to advance the interests of the whole profession. The paper read by P. W. R. Glover, which appeared in the October issue of THE JOURNAL OF ACCOUNTANCY, was an instructive epitome of the conditions controlling the legal regulation of accountancy in the states of the union. Every accountant, whether certified or not, must feel an interest in this vital matter, and the conclusions reached by Mr. Glover, while they may not meet with unanimous approval, will certainly attract attention and conduce to effective thinking. The difficulties which are inherent in political regulation of a profession were ably summarized by the speaker, and although some of us may feel a sense of regret at the discouragement which he displayed with regard to the possibility of restrictive legislation, all must admit the strength of his arguments and be stimulated to greater endeavor for the enlightenment of the public as to the true meaning of accountancy. In the early days when the great aim was merely to have a law written on the statute books the difficulties which have since arisen were not foreseen. Then it was the opinion that when the law providing for certification of accountants had been passed we should come into a kind of land of Beulah. Now having come into a new land we find that Beulah is still ahead. It seems to be inevitable that the course of accountancy legislation shall be more than ordinarily disturbed by the political tactics of legislators and lobbyists.

Accountants' Certificates Discussed

The paper by Henry B. Fernald, which also appeared in the October issue of this magazine, upon the general subject of accountants' certificates led to a discussion which occupied practically an entire session. The subject is one in which every accountant naturally is concerned, even if it does not fall to the individual practitioner himself to sign a certificate. There are many members of the Institute, probably, whose activities do not involve the preparation of certified statements, but even such members are intimately affected by the significance of the accountant's certificate. If the public for whom the certificate really is written can be brought to a full comprehension of the importance which attaches to the accountant's opinion every accountant will be helped forward in his effort to occupy his proper position in the professional world. Mr. Fernald's paper was intended to be and was provocative. Many of the questions which he presented called forth immediate discussion, and there is no doubt that the close attention paid to the discussion was merely a reflection of the enthusiastic interest of the listeners.

The Decade Reviewed

As was expected, the meeting had frequent reminders of the fact that the first decade of the Institute's life had ended. The progress of the profession throughout the country has been remarkable during the ten years since the American Association of Public Accountants was reorganized and took the form of the Institute, and there was a natural feeling of satisfaction in the evidence of growth and progress which the comparative figures revealed. The meeting resolved that the secretary's report, covering the decennial period, should be published in THE JOURNAL OF ACCOUNTANCY and should be given other general distribution as well. The report will be found on another page of this issue. Some of the most remarkable figures which the ten-year summary contains relate to the library and bureau of information. It seems doubtful if the rate of development which this department of the Institute's work has maintained can be paralleled in any other library. The ratio of increase year by year since the library was founded is altogether noteworthy.

To Meet in California

It was the will of the meeting, unanimously expressed, that next year the Institute should meet on the Pacific coast, and after consideration of the invitation extended by the members from California it was resolved that Del Monte should be the place. Those to whom the beautiful country about Monterey is known will not need to be invited to attend a meeting there. There is no more attractive part of the always delightful California coast than that which the Institute has selected. The hospitality of Californians is nationally known. It will be twelve years next fall since the national organization held a meeting west of the Rocky mountains. There is to be a meeting of the Dominion Association of Chartered Accountants in one of the western provinces at a time shortly before or shortly after the Institute's meeting and those who attend one meeting can easily attend both. The members in California are already bestirring themselves to arouse interest in the meeting of 1927. For these and many other reasons it is expected that when the Institute assembles in September next year there will be a large attendance from all parts of the country and that the year which will mark the fortieth anniversary of the founding of the original American Association of Public Accountants will be celebrated in a way commensurate with the importance of the occasion. Californians in the Institute are suggesting that we should draw attention thus early to the selection of Del Monte as a place of meeting, and it is a pleasure to comply with this request.

The Accountant and Economics

One of the changes which will probably take place in the education and experience of the public accountant of tomorrow will be a trend toward the economic view of financial and industrial questions. Heretofore the accountant has been rather inclined to be an accountant and nothing more. By this we mean that he has devoted himself almost exclusively either to what might be called the pure or to the applied science of accounts. He has been inclined to look first toward the accounts and secondarily, or perhaps not at all, toward the great underlying causes of condition. In other words, he has reasoned deductively from apparent facts. In the coming day he will probably change the method of approach at times and follow the more philosophical process of induction. To do that it will be necessary for him to increase his grasp of the economic and social theories. He will be required to be a student of history—and by that we do not mean the text-books which relate the glories of any one race or nation. Already there are evidences of an occasional excursion in the field of political economy, but there has been no widespread migration or even effective inroad into the broader country. There are those who say that a man can not be expected to have a fair comprehension of statistics unless he knows the reasons for the things enumerated. Some folk go so far as to say that one must be a careful student of sociology and many other things as well. But for the most part these are academic counsels of perfection which we have not the slightest intention of putting into practice.

Inheritance and Wealth

All this is induced by a speech recently reported in which there is so striking an example of the force of economic thinking when applied to financial problems that one is led to wonder why we have not more economists among our accountants. The speaker was Sir Josiah Stamp, chairman of the section of economic science and statistics of the British Association. His subject was the theory of inheritance in its relation to the distribution of wealth; and, after a thoughtfully developed process of reasoning, the speaker arrived at certain conclusions which, although he declared them to be purely provisional, are nevertheless of such significance that every student of affairs will feel an interest in them. It is, of course, impossible to reproduce the entire speech which this eminent economist delivered, but the conclusions are brief and they do in effect summarize the entire utterance. There was a time when the question of inheritance was less considerable in this country than it is today. Now we have come into a time of great wealth which in the very nature of things must be passed on from generation to generation, and therefore the country is faced by a problem that must be answered. Here are the conclusions which the speaker reached:

"1. In the past century unprecedented economic advance has been due in the main to the greater use of invention and fixed capital. This has, in turn, made new accumulation of savings possible, and has been made possible by the growing fund of accumulation. In this accumulation the principle of inheritance or bequest has played an important part. Where there has been freedom from the shackles of a family diffusion system the greater progress has been possible. The individual motives which are operative under such a system are stronger than ever, but operate over a diminishing part of the field; they are also stronger over a short period, and of diminishing effect over a long period of time. In other words, communal saving via company reserves (not subjected to the individual volition for saving against spending) and via repayment of debt through funds derived from taxation, and via large capital efforts (housing, &c.) partly financed through taxation, is an increasing proportion of the total. Although some of the values set up by such collective sums may figure in individual estate values, they are not created or destroyed by interference with or promotion of the right of inheritance.

"2. The remaining considerable section of capital accumulation is still powerfully affected by inheritance rights, and would be more affected than heretofore by interference with rights in the direct line, though less affected than hitherto by rights out of that line. More considerable changes might be made in the width of the rights than hitherto without seriously affecting accumulation. On the other hand, the time element is changing—accumulation is just as sensitive in the immediate provision and immediate rights of family enjoyment but less sensitive to change (by restriction or encouragement) in the most remote rights.

"3. The sense of 'social injustice' is directed against inequality of wealth, of which inequality through inheritance is not now the larger part. This sense, if limited to inheritance features, has less economic reaction than is generally supposed. In any case, it is a sense which is not scientifically based. I think it probable that, through the inequalities due to the system in which inheritance has a part, the average man has a slightly smaller proportionate share of the aggregate than he would have had if there had been no inheritance system, but a substantially larger absolute amount, because he shares a larger aggregate or better standard of life than he would have had under a system with no such aid to accumulation. Whether in these circumstances he is justified in having a sense of injustice, whether it is better for human welfare to have a low standard without envy, or a higher one with envy, is a matter lying beyond economics in the sphere of social psychology and philosophy.

"4. The particular claims for unlimited rights of bequest, as settling the best economic direction and control, are gradually losing their force.

"5. The principles upon which death duty taxation is at present based, though they may be the best available when administrative aspects are included, might be improved upon by closer regard to the foregoing analysis. The actual sum now being raised is not necessarily more harmful economically than a similar sum raised by additional income tax, but it is more repressive in accumulation than the same sum would be if a less sum were raised at lower rates on the first succession and the balance were raised at higher rates on succeeding successions."

The calm consideration in this manner of a subject too often regarded as a football in taxation and as a bombshell in radical politics most assuredly has for accountants a value that is not merely intellectual.

British Companies' Acts Amendments

The report of the committee appointed by the British parliament to make recommendations for amendments in the companies' acts of the United Kingdom has been forwarded to the president of the board of trade and by him to the parliament. The companies' acts of Great Britain constitute the legislation under which all corporate activity is conducted in that country, and it has been the policy of parliament from time to time to ask for suggestions for the betterment of the acts so that the commerce of the kingdom might be assisted in every possible way. The British have ever been desirous of furthering the development of their trade, and in consideration of such legislation as the companies' acts there has been rather less of what we should call politics and rather more statesmanship than in many other classes of legislative enactment. The committee which has been considering the question during the past year included one chartered accountant and one incorporated accountant, the former William Cash and the latter Sir James Martin. The committee has been at work for many months and has conducted several hearings. The recommendations which are of interest to accountants on this side of the Atlantic are chiefly those which relate to the election, duties and responsibilities of auditors. On this subject the committee says:

> "We are of opinion that in general the law as it stands with regard to the powers and duties of auditors is satisfactory. It would be a mistake in our view to attempt further to define these by statute having regard to the multifarious circumstances which in practice arise. It appears to us far better that the law should retain its elasticity in this respect than that an attempt should be made to confine it within the bounds of a rigid formula. Cases in which auditors fall below the level of their duty are few and far between. On the other hand, we consider that the protection which the ordinary 'wilful default' clause gives to auditors, as was decided in the *City Equitable* case, is as unwarranted as it is in the case of directors, and we recommend that it should be forbidden. As a corollary to this, we consider that auditors should be entitled to relief under sect. 279 in the same manner as directors.
>
> "Certain of the alterations in the law which we have recommended on the subject of accounts will strengthen the position of auditors by giving statutory sanction to what is already the best professional practice."

Extent of Responsibility

The extremely interesting judgment to which this section of the report refers was rendered on July 11, 1924, in the court of appeal. The substance of the decision is expressed in the following words:

> "I then come to consider whether or not . . . the conduct of Mr. Lepine was wilful so as to render him responsible, or is he relieved by the terms of article 150? Now we find the auditor confronted with a lot of deceit. We find him fulfilling year by year his duty in a manner which has certainly received the praise of those who have given evidence about it and of the learned judge who heard the whole of the facts. We find that on a number of occasions he was successful in putting what was wrong, or attempting to put what was wrong, right, and therefore you find that so far as his will and volition went he was attempting to do his duty. Under those circumstances where you find a default which has been made, and you find an error of judgment in accepting as trustworthy what is now proved to be untrustworthy can you say . . . that he has

been guilty of wilful neglect or default? For my part, for the reasons which I have indicated and upon the evidence to which I have called attention it seems to me impossible so to characterize Mr. Lepine's conduct. He did not, to my mind, shut his eyes to conduct which he thought needed criticism; what he did was, in common with a great number of other persons, he thought the people he was dealing with were trustworthy, and, as pointed out in the cases cited to us, but which I do not stop to actually quote, it has been pointed out again and again that he is entitled to accept the statements which were made to him by those whom he was entitled to trust when he has no reason, or call, for suspicion. It appears to me that the learned judge has quite rightly and accurately applied the law to the facts when he says this: '*If in certain matters he fell short of his* real duty, it was because, in all good faith, he held a mistaken belief as to what that duty was,' and that the auditor conducted the audits honestly and carefully. He made an error of judgment, an error of judgment which might have caused the company, or the directors of the company, to take a different course, and might have possibly saved some portion of the disaster, but in what he did I cannot find that he was guilty of wilful misconduct, and therefore it appears to me section 150 protects him. In those circumstances it appears to me that the learned judge was right in the judgment that he has given, and that this appeal ought to be dismissed, and dismissed with costs."

Section 279 to which reference is made above reads as follows:

"If in any proceeding against a director, or person occupying the position of director, of a company for negligence or breach of trust it appears to the court hearing the case that the director or person is or may be liable in respect of the negligence or breach of trust, but has acted honestly and reasonably, and ought fairly to be excused for the negligence or breach of trust, that court may relieve him, either wholly or partly, from his liability on such terms as the court may think proper."

To Protect the Auditor

We come now to a recommendation by the committee which seems to us the most important in the whole report—at least it is so from the point of view of the auditor. The report says:

"The *City Equitable* case has also drawn attention to the question of the duties of auditors in connection with the verification of securities belonging to the company. It has been suggested to us that the certificate which an auditor should be entitled to accept as to the existence and custody of the company's securities should be fixed by statute, e. g., the certificate of a bank. The evidence does not in our opinion show that any such change in the law is required. Circumstances may justify the acceptance of a certificate in one case which a careful auditor would refuse to accept in another, and we would prefer to see the matter left to the ordinary law of negligence which is sufficiently elastic to meet all cases as they arise. Our recommendation with regard to 'wilful default' clauses in articles gives point to this argument.

"We recommend that—

"(I) The provision mentioned in paragraph 47 above with regard to directors' liability for negligence or breach of duty should be extended to auditors and sect. 279 should be amended so as to include auditors.

"(II) Except in the case of private companies, partners and employees of directors or other officers of the company should be ineligible for appointment as auditors."

Here is the crux of the whole matter. If the directors are to be exonerated from responsibility for errors or omissions of which they are unaware; if the so-called "wilful default" clause is to relieve them from substantial or moral obligation, it is certainly only fair that a similar relief should be extended to the accountant in cases where the neglect or default is conclusively proven to be innocent of intent. Every accountant knows that the shrewd and unscrupulous client may at times be able to mislead if not actually to deceive. The accountant can do his best to exercise reasonable care and diligence, and if he does that it is perfectly natural that he should feel that he has done his duty. Attempts which have been made in the British courts to place the responsibility for error upon the accountant when the accountant has done all that is required by established practice have invariably led to judgment for the defendant. If the introduction of the committee's recommendation in the English companies' acts will make clear the true measure of responsibility which rests upon any professional man a great reform will have been accomplished. The accountant should be responsible when he is wilfully negligent or grossly careless, but only those who regard an accountant as infallible can believe that perfection should be expected of him when it is not expected of any other man. The recommendations of the parliamentary committee seem to us to say that the accountant must do his professional duty and that he must be protected when he has done it.

AMERICAN INSTITUTE OF ACCOUNTANTS

TRIAL BOARD

At a regular meeting of the council of the American Institute of Accountants at Washington, D. C., September 20, 1926, the council, upon motion, adjourned to convene as a trial board to hear charges of unprofessional conduct which had been made against a member of the Institute. The charges were presented by the Institute's counsel. The defendant was present in person, accompanied by counsel.

The charges involved certain allegations of fraud against another member of the Institute which the defendant member had not been able to substantiate. After presentation of the evidence and the defense the defendant and his counsel were excused and the trial board went into executive session.

After discussion of the case it was resolved that the defendant be found guilty as charged. It was also resolved that the defendant be advised of the finding of the trial board and that the penalty imposed be a reprimand and warning against further conduct of the same kind.

It was resolved that in publication of the report of this trial the name of complainant and defendant be omitted.

The defendant was then recalled to the room and received the judgment and admonition of the trial board.

The trial board adjourned and the council reconvened.

Income-tax Department

Edited by Stephen G. Rusk

As has been pointed out in this department on several occasions, accountants handling tax cases for their clients find it necessary at times to revolutionize their ideas that two and two equal four. It is not difficult, upon absorbing the entire subject of federal income and estate taxation, clearly to comprehend the intent of the language of the law. Having equipped himself with this lore, an accountant is sometimes prone to neglect to consult closely the language of a given provision of the law. Placing one's faith in a clear understanding of the theory upon which the taxation is founded, one does not see at once the loopholes provided in the language by which the intent is supposed to be revealed.

If one realizes that congress intended to allow taxpayers a certain amount of relief because of amortization of war facilities, and one should find that the abnormal prices at which such facilities were acquired during the war period were maintained until years after the close of the war, this one, if an accountant, would probably conclude that no amortization was sustained on these facilities. A lawyer, however, would examine closely the language of the act; would take account of the fact that for several months after the armistice was signed the prices of these facilities were temporarily but materially lower than at the date of their acquisition, and base his case accordingly. An eminent lawyer once told the writer that, in his opinion, the amortization sections of the acts of 1917 and 1918 were open to several constructions, not necessarily one that would accord with accountancy theory.

A lawyer would take cognizance of every defect in the language supposed to reveal the intent. He would then build his case, based on a theory which in a minute degree, but effectively, seemed to show that congress had intended something a bit different than that which was commonly accepted. How many cases have we seen successfully brought to issue on some such apparently trivial defect!

This is not written with the thought that all accountants are not alert to this view of the law, for we have heard that the almost successful attempt to upset the commissioner's theory that income tax is a liability for the year in which the things occur upon which the tax is predicated was initiated by a certified public accountant (a woman, we have heard). Once the question was raised, we all saw the force of the arguments underlying her interpretation, and we realized how vulnerable was the commissioner's position, but as his theory was so eminently in accord with our accountancy theory and practice, we realized that we had failed to note that the law itself was subject to more than one interpretation.

How many of us accountants would have thought that the method prescribed by the commissioner for computing excess-profits graduated taxes would be subjected to question? His method seemed so logical and clear and so in accordance with our own method of making such calculations that we did not carefully scan the language of the original act to see whether or not this method was that which congress intended. As it turned out, this theory and method prevailed, but only after several astute lawyers directed the attention of the courts (in litigation on the subject) to the fact that the commissioner's method was not strictly in accordance with the language of the act.

It behooves us always to examine the law carefully—painstakingly; to ponder well as to whether the accepted interpretation is the correct one. Too much reliance must not be put upon the commissioner's interpretations, nor must one rely on one's own preconceived notions as to what is meant by that which is written into the law.

SUMMARY OF RECENT RULINGS

Where a partnership composed of former stockholders of a corporation received the surplus of the corporation on its liquidation in 1919 under an agreement that the surplus should be continued in use by the partnership without any distribution thereof whatever until the firm should be dissolved, the transaction was a distribution of assets, and the surplus so distributed was taxable income for the year 1919, and if the regulations are to be construed as exempting such surplus from taxation, they are void to that extent.

There is a distinction between a dividend as generally understood and a distribution in liquidation, and a surplus assignable to a stockholder in circumstances set forth in preceding paragraph was such a distribution, and the profit realized on the transaction was taxable. (Circuit court of appeals, sixth circuit, *George Langstaff* v. *Robert H. Lucas, collector.*)

Where the only fact averment was the amount of the estate tax returned, the amount found by the commissioner and the amount determined on appeal to the board of tax appeals, the taxpayer's demurrer for failure to state a cause of action was sustained, as the commissioner's finding does not constitute a prima facie case after the board has reached a different result. (United States district court of Pennsylvania, *United States* v. *Rodenbough, executor.*)

Interest paid by a corporation in 1918, accrued for ten years prior, is deductible though never charged on the books before 1918. (United States district court, W. D. of eastern district of Arkansas, *Jungkind Photo Supply Co.* v. *H. L. Remmel, collector.*)

Income from personal property received by executor, beneficially belonging to exempt corporations, was not taxable under 1918 act. (United States district court, S. D. of New York, *Executors of estate of Margaret Olivia Sage* v. *Bowers, collector.*)

Corporation keeping books on an accrual basis (clearly reflecting income), and having made return on such basis, may not change to cash basis for 1917 part of fiscal year ending in 1918. (United States district court, S. D. of New York, *W. S. Barstow & Co., Inc.*, v. *Bowers, collector.*)

Mechanics' liens have priority over federal income taxes assessed subsequent to the filing of the liens. (United States district court, N. D. of New York, *In re Caswell Construction Co., Inc.*)

TREASURY RULINGS

(T. D. 3872, May 21, 1926)

ARTICLE 681: Reserve funds

INCOME TAX—ACT OF 1913—DECISION OF SUPREME COURT

1. *Income—Deduction—Insurance company—Dividend—Premium*

Overpayments of premiums by preferred dividend policyholders in 1912, which were ascertained in 1913 and added to the amount held for future distribution, are not deductible from income for the year 1913 under section II G (b) of the act of 1913 as an amount paid back or credited to an individual policyholder within the year.

2. *Deduction—Loss—Amortization—Securities—Bonds*
Additions to a fund for the purpose of amortizing bonds purchased at a premium are not deductible as a loss sustained within the year under the provisions of section II G (b) of the act of 1913, since no loss is ascertainable until the bonds are sold or paid off.

3. *Deduction—Reserve funds*
The estimated value on December 31, 1913, of future premiums, which were waived on policies after proof of total or permanent disability, is not deductible as a net addition to a reserve required by law, although required by the state superintendent of insurance to be reported and carried as a liability.

4. *Same—Unreported losses*
A special fund required by the state superintendent of insurance to meet unreported losses of policyholders who died during the calendar year, but whose deaths were not reported before the end of the year, is not deductible as a net addition to a reserve required by law, as the item was not reserved from premiums to meet policy obligations at maturity, although it represented a liability.

5. *Same—Annuities*
Additions to a fund set aside to provide for payment of annuities to former soliciting agents of the company are not deductible as a net addition to a reserve required by law, as compensation of soliciting agents has no relation to the reserve held to meet maturing policies.

The following decision of the United States supreme court in the case of *New York Life Insurance Co.* v. *Edwards, collector,* is published for the information of internal-revenue officers and others concerned.

Supreme Court of the United States

712. *New York Life Insurance Co., petitioner,* v. *William H. Edwards, as collector of internal revenue, etc.*

804. *William H. Edwards, as collector of internal revenue for the second district of New York, petitioner,* v. *New York Life Insurance Co.*

[April 19, 1926.]

On writs of certiorari to the United States circuit court of appeals for the second circuit.

Mr. Justice McReynolds delivered the opinion of the court.

The insurance company brought suit in the district court at New York to recover of Edwards, collector, the alleged excessive sum demanded of it as income tax for the year 1913 and obtained judgment for a part. (3 Fed. (2d), 280.) The circuit court of appeals affirmed this except as to one item. (8 Fed. (2d), 851.) Both parties are here by certiorari, and five questions require consideration. All involve the construction or application of the revenue act of October 3, 1913 (ch. 16, 38 Stat., 114, 172). Section II G (a) imposed an annual tax of 1 per centum upon the net income of "every insurance company organized in the United States," and (b) directed:

"Such net income shall be ascertained by deducting from the gross amount of the income of such . . . insurance company, received within the year from all sources, (first) all the ordinary and necessary expenses paid within the year in the maintenance and operation of its business and properties, including rentals or other payments required to be made as a condition to the continued use or possession of property; (second) all losses actually sustained within the year and not compensated by insurance or otherwise, including a reasonable allowance for depreciation by use, wear and tear of property, if any; . . . and in case of insurance companies the net addition, if any, required by law to be made within the year to reserve funds and the sums other than dividends paid within the year on policy and annuity contracts: *Provided*, That . . . life insurance companies shall not include as income in any year such portion of any actual premium received from any individual policyholder as shall have been paid back or credited to such individual policyholder, or treated as an abatement of premium of such individual policyholder, within such year . . ."

1. The company, a New York corporation without capital stock, does business on the mutual, level premium plan, and issues both "annual dividend" and "deferred dividend" policies. Under this plan each policyholder pays annually in advance a fixed sum which, when added to like payments by others, probably will create a fund larger than necessary to meet all maturing policies and estimated expenses. At the end of each year the actual insurance costs and expenses incurred are ascertained. The difference between their sum and the total of advance payments and other income then becomes the "overpayment" or surplus fund for immediate pro rata distribution among policyholders as dividends or for such future disposition as the contracts provide. An "annual dividend" policyholder receives his proportionate part of this fund each year in cash or as a credit upon or abatement of his next premium. "Deferred dividend" or, as sometimes called "distribution" policies provide:

"That no dividend or surplus shall be allowed or paid upon this policy, unless the insured shall survive until completion of its distribution period, and unless this policy shall then be in force. That surplus or profits derived from such policies on the distribution policy plan as shall not be in force at the date of the completion of their respective distribution periods shall be apportioned among such policies as shall complete the distribution periods."

Accordingly, all overpayments by deferred dividend policyholders must await apportionment until the prescribed period ends; and no one of them will receive anything therefrom if his policy lapses or if he dies before that time. The whole of this fund goes to the survivors.

Overpayments by deferred dividend policyholders for 1912 amounted to $8,189,918. The collector refused to deduct this sum from the total receipts, and demanded the prescribed tax of 1 per centum thereon. We think he acted properly. Both courts below so held.

The applicable doctrine was much considered in *Penn Mutual Life Insurance Co.* v. *Lederer* (252 U. S., 523 [T. D. 3046, C B 3, 249]). We there pointed out the probable reason for the permitted noninclusion in the net income of a life insurance company of "such portion of any actual premium received from any individual policyholder as shall have been paid back or credited to such individual policyholder, or treated as an abatement of premium of such individual policyholder, within such year." Here it is insisted that within the meaning of the quoted provision each deferred dividend policyholder's overpayment was actually credited to him during the year; but we can not accept this theory. The aggregate of all such payments was held for distribution among policyholders alive at the end of the period. The receipts for the year were not really diminished.

2. The company owned many bonds, etc., payable at future dates, purchased at prices above their par values, and to amortize these premiums a fund was set up. It claimed that an addition to this fund should be deducted from gross receipts. The district court thought the claim well founded, but the circuit court of appeals took another view. Unless the addition amounted to a loss "actually sustained during the year" no deduction could be made therefor. Obviously, no actual ascertainable loss had occurred. All of the securities might have been sold thereafter above cost. The result of the venture could not be known until they were either sold or paid off.

3. In 1910 the company introduced a clause into some policies by which it agreed to waive payment of premiums after proof of total and permanent disability. The estimated value on December 31, 1913, of future premiums so waived amounted to $16,629. It claimed this should be added to the reserve fund and deducted from gross income. Insurance companies may deduct "the

net addition, if any, required by law to be made within the year to reserve funds."

The pertinent portion of the agreed statement of facts follows:

In 1910 the plaintiff introduced into some of its contracts of life insurance a clause under which it agreed that upon receipt, before default in the payment of premium, of due proof that the insured had become totally and permanently disabled, the plaintiff would waive payment of any premium thereafter falling due. In taking its account at the end of the calendar year 1913, the plaintiff had then received due proof that the insured under a number of these policies were totally and permanently disabled in accordance with the terms of said contracts providing for the waiver of the payment of future premiums. The value at December 31, 1913, of the future premiums waived on account of total and permanent disability was the sum of $16,629. The value at December 31, 1912, of the future premiums so waived was the sum of $5,637.

In the calculation of the general reserve fund at the end of any calendar year, the company and the insurance department of the state of New York make the computation by deducting from the value of the contractual benefits under each policy the then value of all future premiums under the policy. The general reserve fund of the plaintiff stated in its annual statement is thus the reserve computed by deducting the value of all future premiums from the valuation of all policy obligations. But, under the policies on the lives of those who had become totally and permanently disabled and whose contracts provided for the waiver of the payment of future premiums, no future premiums will be received by the plaintiff and, therefore, the net reserve reported for these policies is understated to the extent of the value of these future premiums.

In the official blank for the plaintiff's annual statement to be used at December 31, 1913, there was an item of liabilities, No. 9–a, entitled, "Present value of future premiums waived on account of total and permanent disability," and in the plaintiff's annual statement the sum reported under this item was $16,629 at December 31, 1913. The sum of $16,629 reported under item No. 9–a was not included in the plaintiff's general reserve. In the official blank for use at December 31, 1912, there was no such item as No. 9–a, and the plaintiff included the value at December 31, 1912, of future premiums waived on account of total and permanent disability (viz, $5,637) as a part of the general reserve at that date.

If said sum of $5,637 had not been included as a part of the general reserve at December 31, 1912, the net addition to the value of future premiums waived on account of total and permanent disability would have been the excess of $16,629 over $5,637. Since, however, owing to the change in the form of the official blank, the said $5,637 was deducted as a part of the plaintiff's general reserve in obtaining the net addition to the general reserve, the sum to use in obtaining the net addition to the value of future premiums waived on account of total and permanent disability in the sum of $16,629.

The circuit court of appeals held the deduction should have been allowed, but we think otherwise.

The superintendent of insurance of New York required this item to be reported as a liability and did not treat it as part of the general reserve. Upon the agreed facts we can not say that it was part of any reserve required by the laws of New York. There is nothing to show how "the value of the contractual benefits" under these policies was arrived at, and, considering the evidence presented, we must accept the superintendent's conclusion. The company has not shown enough to establish its right to the exemption.

4. A number of policyholders died during the calendar year, but their deaths were not reported before it terminated. The superintendent of insurance required the company to set aside a special fund to meet these unreported losses, and it claimed that this was an addition to the reserve fund required by law. We think this claim was properly rejected by the commissioner, although the courts below held otherwise. *McCoach* v. *Insurance Co. of North America* (244 U. S., 585) and *United States* v. *Boston Insurance Co.* (U. S.), (November 23, 1925 [T. D. 3792, bulletin V–1, 24]) pointed out that "the net addi-

tion, if any, required by law to be made within the year to reserve funds" does not necessarily include whatever a state official may so designate; that "reserve funds" has a technical meaning. It is unnecessary now to amplify what was there said. The item under consideration represented a liability and not something reserved from premiums to meet policy obligations at maturity.

5. The company also claimed deduction for additions to a fund set aside to provide for payment of annuities to former soliciting agents as provided by their contracts of employment. The commissioner properly rejected this item, although both courts below held a different view. The agreed statement of facts shows:

The plaintiff has a form of contract of employment with many of its soliciting agents under which, if such agents for a period of 20 years continuously devote their entire time, talents, and energies in soliciting applications for insurance, and if they shall for the 20 years accomplish certain prescribed minimum results, then at the end of 20 years of such service each such agent becomes entitled to an income for life payable monthly, the amount of the payment being based upon the results obtained by each such agent during the 20-year period. The laws of New York require the superintendent of insurance, in making a valuation of the obligations of the plaintiff, to value annuities on the standard of McClintock's "Table of mortality among annuitants," with interest not exceeding 4 per centum per annum. Said superintendent of insurance, after making an examination of the plaintiff and valuing its liabilities, required the plaintiff to carry, and it does carry, a fund to meet its said liabilities on said contracts with its soliciting agents; and this fund it increased during the year 1913. The net addition to said fund for said year was the sum of $160,641, which the plaintiff, in making its said return, deducted from gross income under that clause of the law which authorizes a life insurance corporation to deduct the net addition required by law to be made within the year to reserve funds. But in amending said return the commissioner refused to allow said deduction, and thereby made the plaintiff's net income for the year appear to be $160,641 more than it would have been if said deduction had been allowed, and he assessed and collected an additional tax on account thereof accordingly in the sum of $1,606.41, which forms a part of the tax in controversy in this suit.

As pointed out above, the term "reserve funds," in the taxing act, has a technical meaning. The compensation which an insurance company agrees to pay soliciting agents has no relation to the reserve held to meet maturing policies; and when it sets aside a fund to provide payments to such agents this can not be regarded as a reserve within intendment of the statute.

The judgment below must be reversed. The cause will be remanded to the district court for further proceedings in harmony with this opinion.

(T. D. 3921, August 27, 1926)

ARTICLE 42: Sale of personal property on instalment plan.

INCOME TAX

Sales of personal and real property on instalment plan and deferred-payment sales of real property not on instalment plan.

Sections 212 (d), 232, and 1208 of the revenue act of 1926, pertaining to sales of personal and real property, provide as follows:

SEC. 212. (*d*) Under regulations prescribed by the commissioner with the approval of the secretary, a person who regularly sells or otherwise disposes of personal property on the instalment plan may return as income therefrom in any taxable year that proportion of the instalment payments actually received in that year which the total profit realized or to be realized when the payment is completed, bears to the total contract price. In the case (1) of a casual sale or other casual disposition of personal property for a price exceeding $1,000, or (2) of a sale or other disposition of real property, if in either case the initial payments do not exceed one-fourth of the purchase price, the income may, under regulations prescribed by the commissioner with the approval of the secretary, be returned on the basis and in the manner above prescribed in this subdivision. As used in this subdivision the term "initial payments" means the payments received in cash or property other than evidences of indebtedness of the purchaser during the taxable period in which the sale or other disposition is made.

SEC. 232. In the case of a corporation subject to the tax imposed by section 230 the term "net income" means the gross income as defined in section 233 less the deductions allowed by sections 234 and 206, and the net income shall be computed on the same basis as is provided in subdivisions (b) and (d) of section 212 or in section 226. In the case of a foreign corporation or of a corporation entitled to the benefits of section 262 the computation shall also be made in the manner provided in section 217.

SEC. 1208. The provisions of subdivision (d) of section 212 shall be retroactively applied in computing income under the provisions of the revenue act of 1916, the revenue act of 1917, the revenue act of 1918, the revenue act of 1921, or the revenue act of 1924, or any of such acts as amended. Any tax that has been paid under such acts prior to the enactment of this act, if in excess of the tax imposed by such acts as retroactively modified by this section, shall, subject to the statutory period of limitations properly applicable thereto, be credited or refunded to the taxpayer as provided in section 284.

SALE OF PERSONAL PROPERTY ON INSTALMENT PLAN

Dealers in personal property ordinarily sell either for cash or on the personal credit of the purchaser or on the instalment plan. Dealers who sell on the instalment plan usually adopt one of four ways of protecting themselves in case of default:

(*a*) By an agreement that title is to remain in the vendor until the purchaser has completely performed his part of the transaction;

(*b*) By a form of contract in which title is conveyed to the purchaser immediately, but subject to a lien for the unpaid portion of the purchase price;

(*c*) By a present transfer of title to the purchaser, who at the same time executes a reconveyance in the form of a chattel mortgage to the vendor; or

(*d*) By conveyance to a trustee pending performance of the contract and subject to its provisions.

The general purpose and effect being the same in all of these cases, the same rule is uniformly applicable. The rule prescribed is that a person who regularly sells or otherwise disposes of personal property on the instalment plan, whether or not title remains in the vendor until the property is fully paid for, may return as income therefrom in any taxable year that proportion of the instalment payments actually received in that year which the total or gross profit (that is, sales less cost of goods sold) realized or to be realized when the property is paid for bears to the total contract price. Thus the income of a dealer in personal property on the instalment plan may be ascertained by taking as income that proportion of the total payments received in the taxable year from instalment sales (such payments being allocated to the year against the sales of which they apply) which the total or gross profit realized or to be realized on the total instalment sales made during each year bears to the total contract price of all such sales made during that respective year. No payments received in the taxable year shall be excluded in computing the amount of income to be returned on the ground that they were received under a sale the total profit from which was returned as income during a taxable year or years prior to the change by the taxpayer to the instalment basis of returning income. Deductible items are not to be allocated to the years in which the profits from the sales of a particular year are to be returned as income, but must be deducted for the taxable year in which the items are paid or incurred, or paid or accrued, as provided by section 200 (d) of the revenue act of 1926.

In the case of a casual sale or other casual disposition of personal property for a price exceeding $1,000, income may be returned on the instalment basis provided the payments received in cash or property other than evidences of indebtedness of the purchaser during the taxable year in which the sale or other disposition is made do not exceed one-fourth of the purchase price.

If for any reason the purchaser defaults in any of his payments, and the vendor returning income on the instalment basis repossesses the property, the entire amount received on instalment payments and retained by the vendor, less the profits previously returned as income, will be income of the vendor for the year in which the property is repossessed, and the property repossessed must be included in the inventory of the vendor at its original cost, less proper allowance for damage and use, if any.

If the vendor chooses as a matter of consistent practice to return the income from instalment sales on the straight accrual or cash receipts and disbursements basis, such a course is permissible.

The foregoing provisions shall be retroactively applied in computing income from the sale of personal property under the revenue acts of 1916, 1917, 1918, 1921 and 1924, or any such acts as amended. Any dealer in personal property on the instalment plan whose books of account contain adequate information and were kept so that income can be accurately computed on the instalment basis may file amended returns accordingly, and the excess of the amount of any tax previously paid over the tax as computed on the instalment basis as herein provided shall, subject to the statutory period of limitations properly applicable thereto, be credited or refunded.

SALE OF PROPERTY IN LOTS

Where a tract of land is purchased with a view to dividing it into lots or parcels of ground to be sold as such, the cost or other basis shall be equitably apportioned to the several lots or parcels and made a matter of record on the books of the taxpayer, to the end that any gain derived from the sale of any such lots or parcels which constitutes taxable income may be returned as income for the year in which the sale is made. This rule contemplates that there will be a measure of gain or loss on every lot or parcel sold, and not that the capital in the entire tract shall be extinguished before any taxable income shall be returned. The sale of each lot or parcel will be treated as a separate transaction, and gain or loss computed accordingly.

SALE OF REAL PROPERTY INVOLVING DEFERRED PAYMENTS

Under section 212 (d) of the revenue act of 1926 deferred-payment sales of real property fall into two classes when considered with respect to the terms of sale, as follows:

(1) Sales of property on the instalment plan; that is, sales in which the payments received in cash or property other than evidences of indebtedness of the purchaser during the taxable year in which the sale is made do not exceed one-fourth of the purchase price.

(2) Deferred-payment sales not on the instalment plan; that is, sales in which the payments received in cash or property other than evidences of indebtedness of the purchaser during the taxable year in which the sale is made exceed one-fourth of the purchase price.

Sales falling within class (1) and class (2) alike include (*a*) agreements of purchase and sale which contemplate that a conveyance is not to be made at the outset, but only after all or a substantial portion of the purchase price has been paid, and (*b*) sales where there is an immediate transfer of title, the vendor being protected by a mortgage or other lien as to deferred payments.

In the sale of mortgaged property, the amount of the mortgage, whether the property is merely taken subject to the mortgage or whether the mortgage is assumed by the purchaser, shall not be considered as a part of the "initial payments" or of the "total contract price," but shall be included as part of the "purchase price," as those terms are used in section 212 (d) of the revenue act of 1926 and in this treasury decision. Commissions and other selling expenses paid or incurred by the vendor are not to be deducted or taken into account in determining the amount of the "initial payments," the "total contract price," or the "purchase price."

SALE OF REAL PROPERTY ON INSTALMENT PLAN

In transactions included in the first class of deferred-payment sales the vendor may return as income from such transactions in any taxable year that proportion of the instalment payments actually received in that year which the total profit realized or to be realized when the property is paid for bears to the total contract price.

If for any reason the purchaser defaults in any of his payments, and the vendor returning income on the instalment basis repossesses the property, the entire amount received on instalment payments and retained by the vendor, less the sum of the profits previously returned as income and an amount representing proper adjustment for exhaustion, wear and tear, obsolescence, amortization, and depletion of the property while in the hands of the purchaser, will be income of the vendor for the year in which the property is repossessed, and the basis of the property in the hands of the vendor will be the original basis at the time of the instalment sale.

If the vendor chooses as a matter of consistent practice to return the income from instalments sales on the straight accrual or cash receipts and disbursements basis, such a course is permissible, and the sales will be treated as deferred-payment sales not on the instalment plan.

DEFERRED-PAYMENT SALES OF REAL PROPERTY NOT ON INSTALMENT PLAN

In the second class of deferred-payment sales the obligations of the purchaser received by the vendor are to be considered as the equivalent of cash to the amount of their fair market value in ascertaining the profit or loss from the transaction.

If the vendor had retained title to the property and the purchaser defaults in any of his payments, and the vendor repossesses the same by agreement or process of law, the difference between (1) the entire amount of the payments actually received on the contract and retained by the vendor and (2) the sum of the profits previously returned as income in connection therewith and an amount representing proper adjustment for exhaustion, wear and tear, obsolescence, amortization, and depletion of the property while in the hands of the purchaser will constitute gain or loss, as the case may be, to the vendor for the year in which the property is repossessed, and the basis of the property in the hands of the vendor will be the original basis at the time of the sale. If the vendor had previously transferred title to the purchaser and the purchaser defaults in any of his payments and the vendor reacquires the property, such repossession shall be regarded as a transfer by the vendor, in exchange for the property, of so much of the face value of the purchaser's obligations as are applied by the vendor to the purchase or bid price of the property. Such an exchange will be regarded as having resulted in the realization by the vendor of gain or loss, as the case may be, for the year of repossession, measured by the difference between the fair market value of the property and the face value of those obligations of the purchaser which were applied by the vendor to the purchase or bid price of the property to the extent that the fair market value thereof was previously recognized in computing income. The fair market value of the property shall be presumed to be the amount for which it is bid in by the vendor in the absence of clear and convincing proof to the contrary. If the property so acquired is subsequently sold, the basis for determining gain or loss is the fair market value of the property at the date of acquisition.

If the obligations received by the vendor have no fair market value, the payments in cash or other property having a fair market value shall be applied against and reduce the basis of the property sold, and, if in excess of such basis, shall be taxable to the extent of the excess. Gain or loss is realized when the obligations are disposed of or satisfied, the amount being the difference between the reduced basis as provided above and the amount realized therefor.

RETROACTIVE APPLICATION

The provisions of this treasury decision shall be retroactively applied in computing income under the revenue acts of 1916, 1917, 1918, 1921 and 1924, or any of such acts as amended, in accordance with section 1298 of the revenue act of 1926.

All rulings inconsistent herewith are hereby revoked.

(T. D. 3920, August 27, 1926)

ARTICLE 1351: Suits for recovery of taxes erroneously collected
(Also section 231, article 517)

INCOME TAXES—REVENUE ACT OF 1924—DECISION OF COURT

1. *Injunction—Exempt institutions—Section 3224, R. S.*

Under section 3224, R. S., injunction will not issue to restrain the assessment and collection of taxes from a voluntary religious association, although it is exempt from taxes under section 231 of the revenue act of 1924.

2. *Actions—Claim for refund—Section 3226, R. S.*

Under section 3226, R. S., no action for the recovery back of taxes paid can be maintained unless after the payment of the tax a claim for refund has been filed.

3. *Decisions followed.*

The decisions of the supreme court in the cases of *Dodge* v. *Osborn* (240 U. S., 118, T. D. 2301), *Graham* v. *Du Pont* (262 U. S., 234, T. D. 3486 [C. B. II-1, 226]), *Bailey* v. *George* (259 U. S., 16, T. D. 3347 [C. B. I-2, 242]), and *Rock Island Railroad* v. *U. S.* (254 U. S., 141) followed.

The following decision of the district court of the United States for the western district of Michigan, in the case of *Israelite House of David* v. *Holden, collector*, is published for the information of internal-revenue officers and others concerned.

UNITED STATES DISTRICT COURT, WESTERN DISTRICT OF MICHIGAN

Israelite House of David v. *Holden, collector*

[June 16, 1926.]

RAYMOND, D. F.: The bill of complaint filed by plaintiff alleges that it is an unincorporated voluntary religious association organized according to the apostolic plan; that it has one common treasury or community fund; that it is operated exclusively for religious and charitable purposes; and that by the provisions of section 231 of the revenue act of 1924 it is expressly exempted from taxation.

It is alleged that defendant, in disregard of plaintiff's right of exemption, levied and collected from plaintiff a tax for the year 1924 in the sum of $947.06, with interest, and it appears from the bill of complaint and admissions made at the hearing that a penalty was also collected. It is also set forth that plaintiff has protested to the commissioner of internal revenue and that its claimed right of exemption has been denied by said commissioner. Plaintiff prays that defendant be enjoined from imposing upon or collecting any tax from plaintiff under the revenue act of 1924 and that plaintiff have judgment against defendant for the taxes, interest and penalty unlawfully exacted.

The matter is before the court upon motion to dismiss filed by defendant. The substantial grounds of the motion are that plaintiff has an adequate remedy at law, that the bill of complaint does not set forth any ground for injunctive or other relief in a court of equity, and that the suit is brought for the purposes of restraining the assessment and collection of taxes, contrary to statutory provisions.

It seems clear that the bill of complaint states no cause of action of which a court of equity can take jurisdiction. Section 3224 of the *Revised Statutes* is as follows:

"No suit for the purpose of restraining the assessment or collection of any tax shall be maintained in any court."

Counsel insists that this court of equity should determine the status of plaintiff as it relates to the exemption provided by section 231. No case has been cited or discovered which authorizes such a determination. The case of *Trinidad* v. *Sagrada Orden* (263 U. S., 578), cited by plaintiff, was an action at law. In the case of *Kensett* v. *Stivers* (10 Fed., 517), it was held that the collection of a tax can not be restrained by injunction in any court of equity in the United States, however erroneously or illegally it may have been assessed, if assessed by the proper officer. See also *Dodge* v. *Osborn* (240 U. S., 118) and *Graham* v. *Du Pont* (362 U. S., 234). In the case of *Bailey* v. *George* (259 U. S., 16), it was held by Chief Justice Taft that a bill to enjoin a levy and sale of property to satisfy a penalty prescribed as a tax would not lie when it sets up no extraordinary circumstances rendering section 3224 inapplicable and exhibits no reason why the legal remedy of payment under protest and action to recover would not be adequate. No reason is set forth in the bill in this case why the legal remedy is not adequate, and it follows that relief in equity must be denied.

The plaintiff prays for judgment against defendant for the taxes, interest and penalty thereon claimed to have been illegally exacted from it. So far as the relief thus prayed is concerned the plaintiff has an adequate remedy at law. Equity rule 22 provides that if at any time it appears that a suit commenced in equity should have been brought on the law side of the court it shall forthwith be transferred to the law side and there proceeded with, with only such alterations in the pleadings as shall be essential.

It is urged by counsel for defendant that the bill of complaint does not set forth compliance with section 3226 of the *Revised Statutes*, in that it does not appear that appeal has been duly made to the commissioner of internal revenue and his decision had upon such appeal as a condition precedent to the maintenance of suit.

Counsel for plaintiff relies upon the cases of *Weaver* v. *Ewers* (195 Fed., 247), *Loomis* v. *Wattles* (266 Fed., 876), and *Black* v. *Bolen* (268 Fed., 427), in each of which it was held that it was not necessary to file a claim for refund after payment of the tax before commencing suit for its recovery where the tax was paid under protest and the commissioner had previously ruled that the tax should be paid.

This line of cases was expressly referred to in the case of *Rock Island R. R.* v. *U. S.* (254 U. S., 141), and it was there clearly held that the words "on appeal to him made" meant an appeal *after payment.* The following language was used:

"Men must turn square corners when they deal with the government. If it attaches even purely formal conditions to its consent to be sued those conditions must be complied with. Lex non praecipit inutilia (Co. Lit., 127b) expresses rather an ideal than an accomplished fact. But in this case we can not pronounce the second appeal a mere form. On appeal a judge sometimes concurs in a reversal of his decision below. It is possible, as suggested by the court of claims, that the second appeal may be heard by a different person. At all events, the words are there in the statute and the regulations, and the court is of opinion that they mark the conditions of the claimant's right."

The rule laid down makes it clear that unless plaintiff can state a cause of action at law which sets forth compliance with section 3226 as thus construed by the supreme court, such action must be dismissed. The court can not, however, at this time determine the sufficiency of such pleading, as its averments may differ materially from those contained in the bill of complaint.

An order will be entered herein transferring this suit to the law side of the court, with leave to plaintiff to file a declaration at law within 15 days from this date; defendant to plead or file motion to dismiss within 15 days after service of copy of such declaration has been duly made upon attorney for defendant.